BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CAL-RUSS CONSTRUCTION CORPORATION)

Appearances:

For Appellant: Michael C. Calvacca, President

For Respondent: John D. Schell
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Cal-Russ Construction Corporation against proposed assessments of additional franchise tax and fraud penalties in the total amounts of $3,024.22, $775.67, and $720.30 for the income years 1964, 1965 and 1966, respectively..

Appellant is a California corporation formed in 1958 and engaged in the cement contracting business in the Los Angeles area. Its principal shareholders and officers are Mr. Calvacca, the president, and Mr. Russell, the vice president. In its franchise tax return for income year 1964 appellant claimed bad debt deductions in the amount of $44,462.35. Respondent determined that debts written off as worthless in the amount of $31,663.33 had been released or cancelled by appellant in exchange for the debtors' transfer of assets to appellant's shareholders. The particular transactions may be summarized as follows:

1. Linda Oaks Transaction. In 1964 Linda Oaks Development Company owed appellant $6,884.25 for cement work. In exchange for the cancellation of this debt Linda Oaks assigned two notes, each secured by a deed of trust, to Mr. Calvacca and Mr. Russell. The total face value of the two notes was $6,893.83. The maker

of one of the. notes in the face amount of $3,093.83 defaulted after payment of only $51.83 on the principal. Thereafter, the trust deed securing the note was foreclosed and the property sold resulting in a net recovery of $3,439.48. Timely installment payments were being made at all times in question on the second note which had a face value of $3,800.00. Appellant deducted the entire $6,884.25 as a bad debt on its return for the income year 1964.

2. Gardendale Transaction, In exchange for the release of a $14,632.57 debt owed by Gardendale Builders, Inc., to appellant, in 1964 Gardendale transferred a vacant lot subject to an encumbrance of $20,631 to Mr. Calvacca and Mr. Russell. Estimates of the lot's value varied from $30,500 to $38,000. On its 1964 franchise tax return appellant claimed the entire amount of $14,632.57 as a bad debt deduction,

3. Norwood Homes Transaction. In 1964 appellant released a $10,146.51 debt owed to it by Norwood Homes, Inc., in exchange for the transfer to Mr. Calvacca of residential property valued at $37 , 000. The property was subject to a mortgage of $26,000 which Mr. Calvacca assumed. Appellant claimed $10,146.51 as a bad debt deduction on its 1964 franchise tax return.

Respondent disallowed the three amounts claimed above as bad debts for the income year 1964 on the ground that appellant failed to establish that any of -the debts became worthless in 1964. The propriety of this action is the first issue presented in this appeal.

Section 24348 subdivision (a) o:f the Revenue and Taxation Code allows a deduction for "debts which become worthless within the income year." In order to claim the deduction the taxpayer has the burden of establishing that the debt became worthless in the year for which it is claimed. (Redman v. Commissioner, 15'5 F.2d 319; Appeal of Kuhn Enterprises, Inc., Cal. St. Bd. of Equal., Aug. 3, 1965.) The standard for the determination of worthlessness is an objective test of actual worthlessness. The time of actual worthlessness must be fixed by identifiable events which form a reasonable basis for abandoning any hopes for future recovery.' The actual financial condition of the debtor, as evidenced by some event or substantial change which adversely affects his ability to make payment, furnishes

the primary test of worthlessness. (W. A. Dallmever, 14 T.C. 128 2; H. W. Findley, 25 T.C. 311, aff'd per curiam, 236 F.2d 959; Grace Bros. Brewery Co., Cal. St. Bd. of Equal., June 28, 1966.)

Here, the record is totally devoid of any information concerning the debtors' financial condition. Appellant offered no evidence tending to establish that the debtors were unable to pay the amounts due, either in whole or in part. On the contrary, the evidence indicates that in each instance valuable assets approximating or exceeding the debt due were transferred to appellant's shareholders in exchange for the release of the debtor or cancellation of the indebtedness. A valid bad debt deduction does not arise where the taxpayer, for a consideration that is satisfactory to himself, either cancels a debt or releases a solvent debtor from liability. (George F. Thompson, 6 T.C. 285, 294, aff'd per curiam, 161 F.2d 185; Civilla J. Brubaker, 28 T.C. 1281, 1288.)

As an alternative contention appellant apparently argues that it is entitled to deduct at least part of the bad debt deduction claimed. However, appellant! s contention of partial worthlessness is infected with the same fatal defect noted above; the record is totally barren of any evidence tending to establish that the debts became even partially worthless during the income year 1964. In the absence of any evidence concerning the debtors' financial condition this contention must also fail. Accordingly, respondent% action in denying the bad debt deduction in the total amount of $31,663.33 for the income ye-ar 1964 is affirmed.

Respondent also determined that in each of the years in question appellant improperly deducted, as rental expense, items which were actually payments on debts owed either by appellant or its shareholders. More specifically the items deducted included payments by appellant on the Gardendale indebtedness assumed by Mr. Calvacca and Mr. Russell; payments to Riverside Cement Company, a creditor of appellant; and a third amount which reflected payments to Mr. Russell, allegedly, for the use of a building owned by him. Apparently, appellant does not seriously contest the disallowance of the first two.items. However) it does contend that the payments to Mr. Russell were properly deducted as rental expense.

In support of its position appellant asserts that the building was used as an office and storage

facility and was owned by Mr. Russell who leased it to the corporation. The record indicates that the property had previously been owned by Mr. Calvacca and Mr. Russell as tenants in common and was transferred to Mr. Russell as his separate property early in 1964. Appellant also submitted a standard form agreement which purported to lease the subject property from Mr. Russell to appellant for a five year term commencing January 1, 1965, for a total consideration of $30,000 or $500 per month.

Respondent argues that the acquisition of this property by Mr. Russell was similar to the property acquisitions involved in the bad debt issue considered above. The purpose of the entire transaction was to place nominal ownership of the property in Mr. Russell to allow him to receive payments from appellant until he recovered an amount equivalent to that received by Mr. Calvacca in the Norwood Homes transaction. From this respondent concludes that the transaction served no legitimate business purpose and should be disregarded for tax purposes as a sham. We agree.

When the record is viewed in its entirety it appears that the transaction was without substance and effect for tax purposes. It is noted. that Mr. Calvacca received a net benefit In the Norwood Homes transaction approximately equal to that which Mr. Russell received under the purported lease transaction. Immediately after receiving $11,500, allegedly as rental payments, Mr. Russell transferred the property to appellant although three years of the original five year term remained. The record also shows that appellant was occupying the building at least as early as June 1964 although the purported lease did not commence until the following year. The record does not indicate that appellant was paying rent for the use of the property prior to the commencement of the lease. The inevitable conclusion is that appellant considered the -property as its own prior to the nominal transfer to Mr. Russell and that the temporary transfer was only for the purpose of channeling income from the corporation, to one of its shareholders. The entire transaction was merelv an attempt to shuffle income between related taxpayers and must be disregarded for tax purposes. (Catherine G. Armston, 12 T.C. 539, aff'd, 188 F.2d 531, 533; R.E.L. Finley, 27 T.C. 413, 423, aff'd, 255 F.2d 128.) Thus respondent's disallowance of the amounts claimed as deductions for rental expense in the income years 1964, 1965 and 1966 must be affirmed.

Respondent also asserted the 50% penalty prescribed in section 25935 of the Revenue and Taxation Code for fraud with intent to evade tax. The burden of proving fraud is upon the respondent and it must be established by something impressively more than a slight preponderance of evidence. Proof of fraud must be clear and convincing. (Valetti v. Commissioner, 260 F.2d 185,188; Appeal of George W. Fairchild, Cal. St. Bd. of Equal., Oct. 27, 1971.) Fraud implies bad faith, intentional wrongdoing and a sinister motive. (Jones v. Commissioner, 259 F.2d 300, 303; Powell v. Granquist, 252 F.2d 56, 61.) The taxpayer must have the specific intent to evade a tax believed to be owing. (Powell v. Granquist, supra.) In determining the existence of fraud it is the state of mind of the taxpayer during the period in question with which we are concerned. (Powell v. Gransuist, supra, at p. 61.)

Since a corporation can act only through its officers corporate fraud necessarily depends upon the fradulent intent of the corporate officers, (W. R. Jackson, T.C. Memo., Dec. 23, 1964, aff'd, 380 F.2d 661; Auerbach Shoe Co., 21 T.C. 191 aff'd, 216 F.2d 693.) Thus, in determining fraudulent intent on the part of appellant the acts of its officers taken in its name and on its behalf are controlling. (George M. Still, Inc., 19 T.C. 1072, 1077; Saven Corp., 45 B.T.A. 343, 355.) While it is *true* that fraud may be established by circumstantial evidence (Powell v. Gransuist, supra, at p. 61.), it is never imputed or presumed and findings of fraud will not be sustained upon circumstances which, at best, create only suspicion. (Jones v. Commissioner, supra, at p. 303.)

Here respondent attempts to establish fraud by asserting that appellant offered no evidence or argument with regard to the civil penalty and concluding that the transactions involved clearly demonstrate willful attempts to evade tax. While the facts of this case are at least suggestive of the possibility of fraud, an equally plausible conclusion is that the deficiencies resulted from ignorance, honest mistake, or negligence, none of which constitute fraud. In our opinion respondent has failed to sustain his burden of proving fraud in this case and, accordingly, the fraud penalties cannot stand.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Anneal of Cal-Russ Construction Cornoration

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Cal-Russ Construction Corporation against proposed assessments of additional franchise tax in the amounts of $2,016.15, $517.11, and $480.20 for the income, years 1964, 1965 and 1966, respectively, be and the same is hereby sustained, and that the action of the Franchise Tax Board on the protest of Cal-Russ Construction Corporation against proposed assessments of fraud penalties in the amounts of $1,008.07, $258.56, and $240.10 for the income years 1964, 1965 and 1956, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 14th day of November, 1972, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary